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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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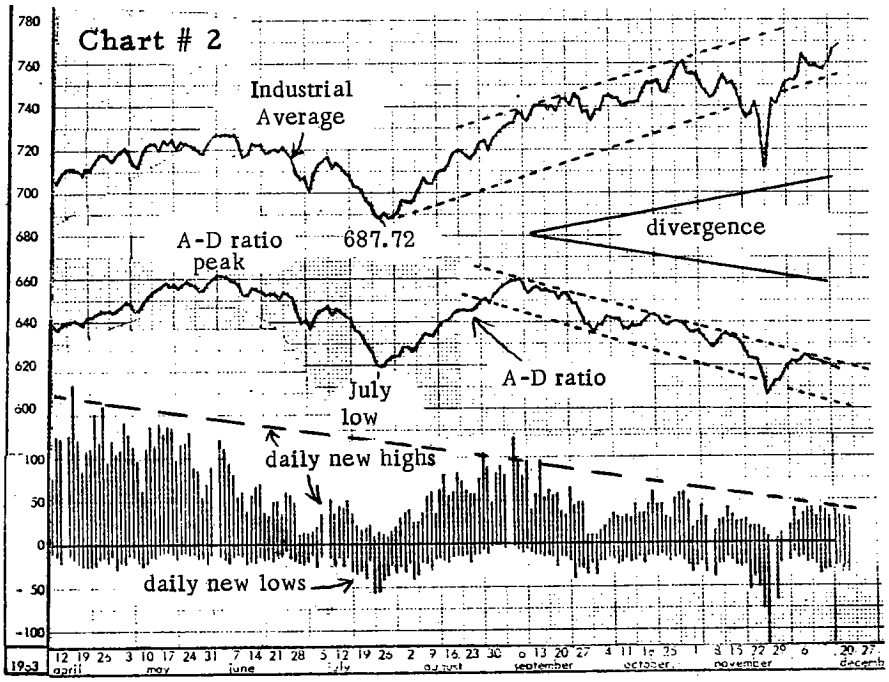
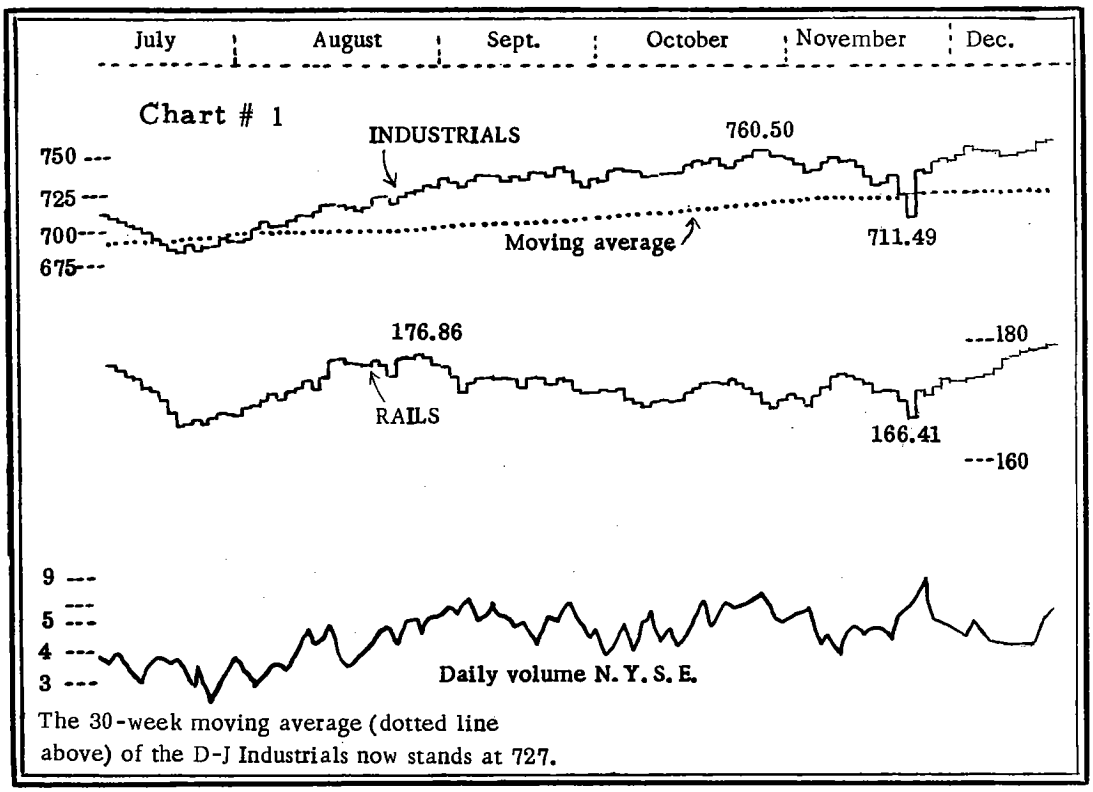
THE MARKET As this Letter is written (see Chart #1), Rails are at their highest level since 1956, Industrials are at an all-time high, and newspapers and magazines are vying with each other in producing optimistic predictions and projections for 1964.

Strangely however, the majority of stocks on the N.Y.S.E. seem to be immune from the bullishness of both the economic forecasters and the Averages. Chart #2 shows that the advance-decline ratio (representative of the trend of the majority of stocks) is far below its peak of September or May, 1963. This dangerous picture is being confirmed by the daily new high totals (Chart #2), and here we see that new highs are exhibiting a great reluctance to rise above the 40 area. This means that with the two Averages at or near all-time highs, only 3% of the listed stocks are recording daily new highs of their own, a far cry from the 130-180 daily new highs of April and May, 1963. As an added comment on total breadth, on December 18 as the D-J Industrial Average touched a record high, the A-D ratio on the American Exchange recorded its lowest level since the peak set in March, 1959.



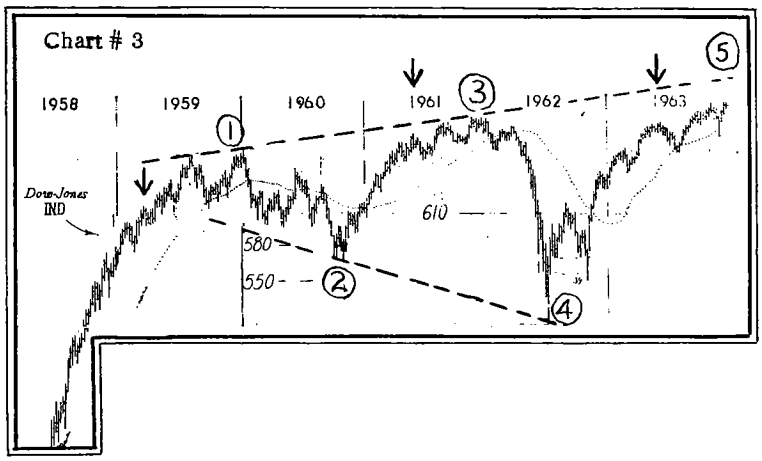
The last Letter went into great detail to show why an area characterized by divergence between the Industrial Average and the A-D ratio should be considered a selling area. The month of December is traditionally a month of rising prices on Wall Street, and so far, the seasonal (December) odds have favored this market. I would use the current rally as an opportunity to swap stocks for cash.

POINT FIVE On a few occasions in 1962 I drew readers' attentions to the possibility that a giant "broadening pattern" might be forming in the Industrial Average. A broadening formation is a five-point reversal pattern — with each high above the preceding high and each low below the preceding low. Such phenomenons are extremely rare, and they are a product of a market which is frenzied or "out-of-control". According to Robert Edwards (Edwards & Magee, "Technical Analysis of Stock Trends") nine out of ten broadening formations are bearish in implication. Just as a long,



The 30-week moving average (dotted line above) of the D-J Industrials now stands at 727.

dull "line" following a major decline usually implies an area of informed accumulation, a broadening structure following a major advance implies distribution. There have been exceptions, and broadening patterns have been known to break out of the top of their upper trendlines — but such action is very unusual.



The giant structure pictured in Chart # 3 has no equal in the history of the Averages. Nothing like it has ever occurred from the standpoint of sheer duration and extent (although a three-month broadening top did appear in 1957 just before the 100-point autumn decline). I have marked the four major reversal points on Chart # 3. If the Industrial Average now rises to point number 5, it will have risen to the vicinity of 795.

The three arrows mark the points at which the advance-decline ratio recorded peaks and turned down. As seen on the chart, there was a ten-month lag between the peak on the A-D ratio in 1959 and the final peak on the Dow; in 1961 the lag was seven months. In the current instance, the A-D ratio turned down on May 31, 1963, seven months ago.

Will the huge broadening structure "break out" on the upside, or will point 5 on the chart mark the end of the 1962-63 Industrial rise? My belief, based on the bearish implications of the broadening formation itself and based on the fact that the majority of stocks (as measured by the A-D ratio) have been in a declining trend for seven months already, is that point 5 (in the 795 region of the Dow) will very likely mark the termination of the Industrial rise.

QUESTION: What is the significance of the recent Rail confirmation (the Rail bettering of their August 31 high)? What would it mean if Rails bettered their 1956 high of 181.23, thereby confirming Industrials in a primary sense for the first time in seven years?

ANSWER: I can only go by my own market instinct and the lessons of history. As far as this market is concerned, one may place the beginning of the bull movement either in June, 1949, or in June, 1962. Either way, it seems to me that despite the Rail confirmation, it is late in the game. I say it is late because investment grade stocks are now selling near the highest valuation the market has ever placed on record earnings. Furthermore, stocks have been selling at inflated prices since late-1958, which is the longest period of overvaluation (to my knowledge) ever seen in the market.

On July 7, 1933, Rails struck a peak of 56.53. Despite a continual succession of new bull market highs in Industrials, Rails did not better their 1933 high until September, 1936. At that time Robert Rhea wrote: "In the opinion of the writer, the fact that the Rails finally bettered the 1933 highs is of no particular forecasting significance because of the extreme age of the older objective. No similar condition was ever recorded in the Averages. The event does, however, delight those students who demand complete fulfillment of every technical detail." The rise in the Averages continued until March, 1937, at which time the extraordinary 1932-37 bull market expired.

My own opinion is that the recent upward rush of the Rails and the possibility of a Rail bettering of the 1956 high should not be taken as indicating a new boom in the market. Stocks are still overvalued, and the Averages have been pushing up for a long time. A Rail rise above 181.23 would in some ways be spectacular, but I personally would not revise my cautious approach to the market if the 181.23 mark is surpassed.

QUESTION: What do you, yourself, expect to do in coming months as far as handling your own funds is concerned?

ANSWER: In my opinion, the action of the market has been, and is, implying trouble ahead. No one can know whether the breadth-price divergence (of which I have written so much) will result in a secondary reaction or a major collapse. Therefore, if the Averages continue to push ahead I will stay out of the market entirely. If I did own stocks, I would use any further rise in the Averages as a selling opportunity.

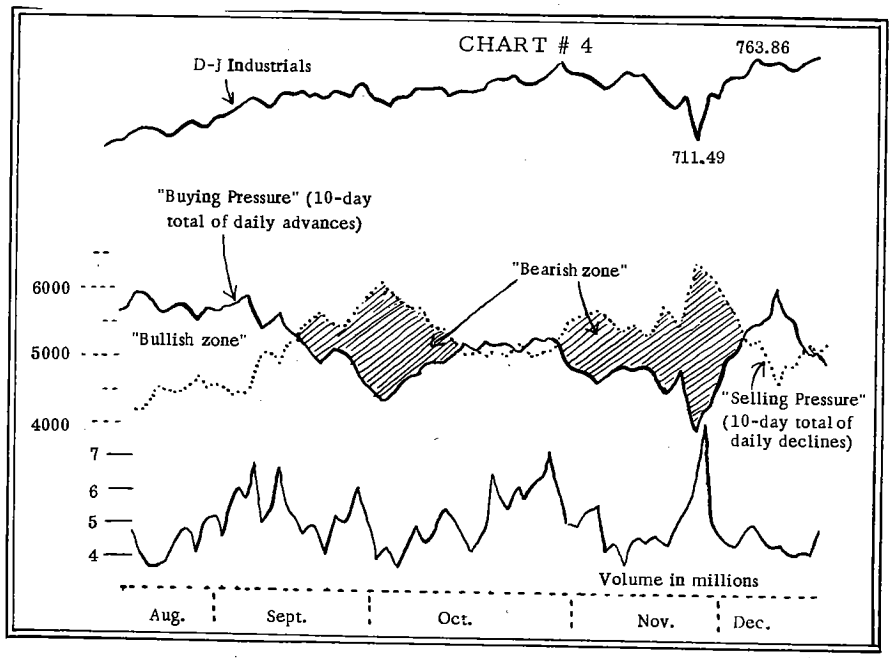
However, if in the next few weeks or if in the first quarter a reaction begins, I will watch it carefully, attempting (if I am able) to judge whether it is corrective action or major bear market action. If it is corrective, I will prepare to buy the better acting stocks at or near the termination of the reaction. But if the decline appears to be of the true bear market variety, I will move all my funds into 90-day U. S. Treasury Bills.

In a true primary bear market, I would expect all market instruments to decline, whether they are Treasury bonds, corporate bonds, commodities, preferred stocks, convertible bonds or common stocks. There has not been such a decline in a generation. It is worth noting that such declines have (in the past) been brought on by a credit collapse in the private sector of the economy.

QUESTION: Do you personally believe that the next major downturn will be a reaction or a collapse of the variety referred to above?

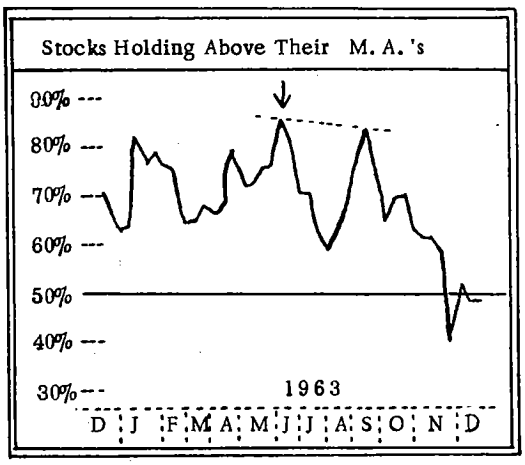
ANSWER: I wish I knew. I believe that a major collapse is coming. But I still cannot rule out the possibility of one more speculative rise first. Historically, most speculative rises have begun immediately after violent reactions as per 1958-59 or 1960-61. The 1962-63 rise, however, never did draw in the public. I do not think a continued rise from here will turn the public bullish. The one thing that might bring the public in is a sharp, even violent, correction which would serve to make the public believe that stocks were on the bargain counter again. Along these lines, it is extremely important to remember that the odd-lot public normally tends to increase buying on declines ("lower prices are bargains") while decreasing buying on advances ("stocks are a sale at higher prices"). It is exactly this psychology which makes me skeptical regarding the public's "coming in" if the Averages continue to rise. If the public has not regained its appetite for stocks during the entire rise since mid-1962, they are not apt to regain it if the Averages continue to rise from here.

BUYING AND SELLING PRESSURE (Chart #4)
Simply stated, this study shows when the forces of selling are dominant and when the forces of buying are dominant. If, over a ten-day period, more stocks went down than up, the dotted line (representing Selling Pressure) will move above the solid line (representing Buying Pressure). The converse is true, of course if more stock went up than down over a ten-day period.



The study shows that since late September the forces of selling have been dominant in the market. During late October the two forces were in equilibrium and during early December the forces of buying moved ahead for a short period. As seen on the chart, the Buying line started down again on December 9, and early last week Selling actually climbed slightly above Buying. All this occurred while the Industrial Average was rising into all-time high ground. This study implies that a great deal of distribution has been taking place under the guise of new highs in the Averages. At no time since mid-September has the Buying line moved far above the Selling line.

STOCKS Of 432 stocks tabulated here weekly, 212 or 49% are now holding above their own 200-day moving average. As seen on the accompanying chart, this represents no change from last week, and the "bullish percentage" is still under the important 50% level. This study remains bearish.



At this time, I believe a review of some of the more interesting groups and stocks in those groups may be worthwhile. The Aircraft group has been acting poorer than the market (i.e., declining relative strength) since the end of 1962. Recently, Aircraft relative strength (R.S.) has turned higher, but it is too early to tell whether this is an important turn or not. Martin-Marietta is the best-acting in the group.

Airline R. S. has been going straight up since mid-1962. This group has been strong through the entire 1962-63 rise. This group reached its height of popularity (R.S.) in 1946, and its R.S. line has never approached that area since.

Autos have now reached the highest level of R.S. in their history, and this group has also been strong through the entire 1962-63 rise. Chrysler and GM are doing the upside work, while Amer. Motors and Ford and lagging behind the market.

Auto Equipment acts badly, which is strange considering the strength of Autos. Bendix, Borg-Warner, Thompson-Ramo, for instance, have acted poorly all year.

Building Stocks are another mystery. The group has been dropping in R.S. ever since 1958. R.S. of the group is now at the low. Perhaps the market is "saying" that the building boom is over. Such blue-chips as National Lead, U.S. Gypsum, Johns Manville, never approached their 1961 highs during 1962-63.

Business Machines and Chemicals have been moving sideways in R.S. over the past year, acting no worse nor better than the market.

Electrical Equipment has moved slightly higher in R.S. during 1963. The best acting stock in this group and one that has frequently been mentioned in these Letters is Sperry-Rand (see chart on page 4).

Farm Machinery has been improving in R. S. since early 1962. Allis-Chalmers has been the "dog" and Deere the hero. International Harvestor has moved with the market over the past three years.

Finance Stocks in general act poorer than the market. Bank stocks touched a high in popularity in 1929; they dropped in R. S. for 27 years after that binge. In 1956 bank stock R. S. turned up to touch a minor peak in 1961. Since then bank stocks have acted slightly worse than the market. Lately, the whole credit group seems to have "topped out" and this includes small loan companies, auto finance companies, savings and loan stocks and factoring companies. Stay away from the group — there's something wrong here.

Golds have acted worse than the market since June, 1962. Most of the leading golds have held well above their 1962 lows and volume has been low on the decline. Campbell and Dome have held well since September and the worst may have been seen.

Machinery Group recorded an all-time peak of R. S. in 1959; since then it has been declining in popularity. Despite well-advertised record totals of tool orders, such stocks as Amer. Machine & Foundry and Blaw-Know cannot get started. Best acting in the group is Caterpillar Tractor with Bucyrus-Erie trying to get going but having a hard time.

Mining group turned up sharply in December, 1962. Lately, the group has moved sideways. Amer. Smelting and St. Joseph lead have been the winners here, with Anaconda and Kennecott in trouble. R. S. on the last two has dropped to the lowest level in many years. Trouble could come in the form of a takeover of mining reserves in Chile.

Oil group rose in R. S. from 1931 through 1957. From 1957 to 1960, Oils dropped sharply in R. S. During 1962-63 Oils moved up again in R. S., but the R. S. line turned sharply down in August, 1963. Getty, Shell and Jersey are the best acting in the group, but I do not like buying a good stock in a group that does not act well.

Paper group zoomed from a low in popularity during 1933 to a high in 1956. Since then, it's been tough sledding. They may be ready for another rise in popularity over the foreseeable future.

Retail: Department stores have been slightly behind the market since early 1962; mail order is enjoying the greatest R. S. in its history; variety chains saw a peak in R. S. in 1936, have been dropping in popularity ever since. Variety chains are now at their lowest levels of R. S. since the 1920's, and they could represent some of the best actual values on the Board (see Barron's, December 16, page 3).

Steels rose from a low in R. S. in 1933 to a high in 1959. They have been behind the market ever since. All during 1963 steel R. S. has been moving sideways, and it is possible that they will start acting better than the market for a while. Best acting in the group is Jones & Laughlin; worst acting Bethlehem.

Utilities hit a high in popularity in 1928, and it took almost three decades for the group to recover from that unbelievable optimism. The group touched its low of R. S. in 1956 and acted generally better than the market through to September, 1962. Since then, Utilities have turned down in R. S. Whether this decline in popularity represents a correction in R. S. or important distribution, no one can know. I would not want the group, however, until they begin to act better than the market again. Note on the Wall Street Journal stock chart that the Utility Average has been extremely sluggish on the recovery from the November 22 lows.

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The weekly chart of Sperry-Rand calls attention to one of the best acting stocks on the Exchange. Note that the stock is rising on increasing volume and that SY's relative strength is also improving on a trend basis. If SY's relative strength line can hold within its upwards channel through a general market decline, it will be one of the stocks which I'll be ready to buy.

Late Note: The market performance of December 18 was (to my mind) particularly bad. To the tune of a new high on Industrials and Rails, 111 more issues declined than advanced and new highs were only 41 against 36 new lows. My A-D ratio on December 18 zig-zagged down and dropped to its lowest level since November 27. If you own stock in this market, you have more nerve than I have.

Chart #3 courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Chart of Sperry Rand courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.